

THE COMPLIANCE OF BEST PRACTICES OF BOARD STRUCTURE AND ITS IMPACT FOR THE FINANCIAL PERFORMANCE IN SRI LANKA. (DIVERSIFIED HOLDINGS LISTED COMPANIES IN COLOMBO STOCK EXCHANGE)

Jayani Shamika Hewathenna, Athambawa Haleem and Athambawa Jamaldeen

Department of Accountancy and Finance,
Faculty of Management and Commerce,
South Eastern University of Sri Lanka, Sri Lanka
jayanishamika@yahoo.com, haleematham@gmail.com, ajamaldeen@seu.ac.lk

ABSTRACT

Board Structure is an important Corporate Governance mechanism, which would result in improved firm performance. Boards play an important role in advising top management. Purpose of this study was to examine the relationship between Board Structure and financial performance in Diversified Holdings Listed companies in Sri Lanka. It investigates the Board Size and Composition of Boards of Directors in Diversified Listed Holdings companies and analyses whether Board Structure has an impact on financial performance, as measured by return on equity (ROE) and return on Assets (ROA). On the extensive literature, five board characteristics (Board Size, Board balance, Appointment to the Board, Performance appraisal of Board and Performance appraisal of CEO) have been identified as a possibly having an impact on financial performance of company and these characteristics were set as the independent variables. This study was a comparative analysis to gauge the changes to corporate governance practices from 2009/10 to 2013/14. A sample of 11 companies was selected from the top of 22 listed Diversified holdings companies in Sri Lanka. Findings of the study revealed that there is a significant negative impact of Board Size on ROE and insignificant negative impact on ROA. Non-executive directors sitting on the Board negatively impact on ROE and ROA. Evidence also existed that there is a significant positive relationship between Appointments to the Board and Performance Appraisal of the CEO with ROA. However, there is a significant negative relationship observed between Performance Appraisal of Board with ROE and ROA.

Keywords: Board Structure, Financial Performance, Return on Equity, Return on Assets.

INTRODUCTION

Best practices of board structure have become popular arguments among developed and developing countries. It determines financial performance of organization and protects the interests of shareholders' attention. And also, a Best practice of board structure is having considerable significant implications for the growth prospects of an economy. In addition to that best practice of board structure is important regarded as reducing risk for investors, attracting investment capital and improving the performance of companies. However, the way in which corporate governance is organized differs between countries, depending on their political, economic and social context. As the structure of the board of directors as a corporate governance mechanism has received considerable attention in recent years from academics, market participants, and regulators. The Institute of Chartered Accountants of Sri Lanka was introduced Corporate Governance to Sri Lanka. The first code "code of best practices on matters related to financial aspects of corporate governance" on December 1997. This was the voluntary best practice Code, guided by Corporate Governance publications, then globally applicable.

In Sri Lanka, effective corporate governance is considered as ensuring corporate accountability, enhancing the reliability and quality of financial information, and therefore enhancing the integrity and efficiency of capital markets, which in turn will improve investor confidence. As the requirement has become essential board structure which become an essential factor influence to the board effectiveness. Agency theorist argues that in order to protect share holder interest, the board of directors must assume an effective oversight function. It is assumed that that board performance of its monitoring duties in influenced by the effectiveness of the board, which in turn influenced by the factors such as proportion of outside directors and quality, size of board, duality of chief executive officer, board diversity, information asymmetries and board culture (Brennan, 2006).

However, the monitoring function is clearly a vital one boards to play and if anything it has become even more salient following the wake of recent corporate scandals and legislation. But monitoring is not only role that boards needs to play. So, the code of best practices on corporate governance has become important to govern the board of directors. According to the requirement of the social phenomena Sri Lanka Code of best practices on corporate governance has updated time to time. Researcher will use the guidelines and recommendations included in Code of Best practices on corporate governance which is issued jointly by the Security and Exchange Commission of Sri Lanka and The Institute of Chartered Accountants of Sri Lanka in year 2013. Corporate Governance Recently received a lot of attention from Policy makers and academic Researchers. This study examines whether the best practice of board structure has impact on financial performance of the organization. Hence, the main objective of the research is; to examine whether Board structure influence on financial performance. And also researcher has formulated the conceptual framework by defining independent variables (Board Size- H1, Board Balance H2, Appointments to the Board-H3, Performance Appraisal of the Board –H4 and Performance Appraisal of the CEO-H5) which influence on dependent variable (Firm performance (ROE and ROA)).

HYPOTHESIS

The hypothesizes of this research are,

H1: There is a positive impact of the Board Size on Financial Performance

H2: There is a positive impact of Board Balance on Financial

H3: There is a positive impact of Appointments to the Board on Financial Performance

H4: There is a positive impact of the Performance Appraisal of the Board on Financial Performance

H5: There is a positive impact of the Performance Appraisal of the CEO on Financial Performance

METHODOLOGY

Sampling Methods and Analysis

The official list of companies in the Colombo Stock Exchange (CSE) contained 293 companies in year 2014 and it has been categorized under 20 different sectors according to the core business activities of the company. Under listed companies of CSE, Diversified sector had been selected as sample of the study. It was taken 22 Diversified Holding Companies listed on the CSE as research population. As a final sample it was selected 11 diversified holding companies as a final sample since there was 11 diversified companies listed in CSE in year 2010/11. Therefore based on the availability of information from year 2010/11 it was selected 11 companies. Also, with regard to data, it was used 4 years' time series for this study. The study used secondary data were obtained for analysis from the annual reports of respective companies, interim financial reports and CSE publications. In order to find a

relationship between board structure and financial performance, Descriptive statistics, Correlation analysis and Regression analysis were used.

ANALYSIS AND RESULTS

It shows that all the variables used for the research in descriptive analysis way. The mean of the Board Size is 9. In here, researcher has identified that average Board Size is less than 10 and it is complied with the previous studies (The Cadbury committee report 1992, Num and Lum 2005, Lipton and Lorsch 1992 and Manawaduge 2012). Average of Board Balance is 62.78 and it indicates that within the Board size more than 50% of them are Non-Executive Directors.

Correlation analysis shows that Pearson correlation predicted the followings as -0.327, -0.151, -0.111, -0.129, and -0.118 respectively insignificant negative relationship of Board Size, Board Balance, the Appointments to the board and the performance appraisal of the board and CEO with the ROE in Diversified Holding companies in Sri Lanka. There is a positive law relationship of Board Size and ROA as 0.056. Pearson correlation -0.234 indicate a negative relationship with proportion of Non-Executive directors with ROA. The Appointments to the board through the Nomination committee with ROA shows positive low relationship as 0.231. And also Performance appraisal of the Board and CEO shows respectively negative low (-0.052) and positive low (0.112) relationship with ROA.

Model Summary

R Square value is shown the explanatory power of the independent variables. It has indicated that the variation of independent variables are resulted to variation of ROE 23.1% in model 1 and it has a positive influence board structure on ROE but not significant. And also the variation of independent variables is resulted to variation of ROA in 23.3% and it also has an insignificant positive influence of board structure on ROA.

Table.1: Coefficients

Model	Unstandardized Coefficients				Standardized Coefficients		t	Sig.(P)		
	B		Std. Error		Beta					
Dependent Variable	ROE	ROA	ROE	ROA	ROE	ROA	ROE	ROA	ROE	ROA
(Constant)	77.709	14.413	17.476	3.503			4.447	4.115	.000	.000
Board Size	-5.352	-.701	1.838	.368	-.632	-.412	-2.912	-1.902	.006	.065
Board Balance	-.169	-.043	.134	.027	-.186	-.234	-1.258	-1.590	.216	.120
Appointments to the Board	10.052	3.102	7.505	1.504	.280	.430	1.339	2.062	.188	.046
Performance Appraisal of the Board	-19.778	-4.997	9.709	1.946	-.559	-.703	-2.037	-2.568	.049	.014
Performance appraisal of the CEO	13.873	4.285	10.051	2.015	.377	.581	1.380	2.127	.176	.040

Dependent Variables: ROE, ROA

Out of these 5 board structure, Appointments to the Board and Performance appraisal of the CEO has positive impact on ROE but not significant. Board Size and Performance Appraisal of the Board have significant negative impact on ROE. Board Balance has insignificant negative impact on both ROE and ROA. Appointments to the Board and Performance appraisal of the CEO has significant positive impact on ROA.

Furthermore Performance Appraisal of the Board has significant negative impact on the ROA.

CONCLUSION & RECOMMENDATION

The Board structure is considered as important determinant for effective corporate governance and it improving firm performance in volatile environments. It was founded that board structures resulted in accountability to shareholders through firm performance, which is considered important for investors and international lending agencies in the current environment. It was investigated the relationship between corporate governance mechanism and the financial performance of listed Diversified companies in Sri Lanka. It summarizes the results of the study as follows. According to the regression result of the research it was not supported the first (H1) and second (H2) hypothesis. As well as it could be identified that there is a positive impact of Appointments to the Board with financial performance and the third hypothesis of this study (H3) was supported. Performance Appraisal of the Board was shown a significant negative impact on Financial Performance and that was not supported the fourth (H4) hypothesis. Moreover researcher had identified a positive impact of Performance appraisal of the CEO on Financial performance and it was supported the fifth (H5) hypothesis.

This finding suggested negative value of the board size indicates that the increase in board size causes the decrease of firm performance. Effective structure of board along with their capacities, capabilities, skills, knowledge and experience will be get more advantages rather board size. And also it can be suggested that the directors of the Board should perform on beyond assigned subject of the companies other than their duties what they have empowered by company. Way of performance appraisal of the board and CEO's are not clearly mentioned in some company's annual report as evidence and most of companies didn't have appraisal performance record of the boards and CEOs. And also, most of the companies used "code of best practice on corporate governance rules" as title to meet mandatory requirements of listed organizations in CSE. But it has a doubt whether all the organizations are really perform on the code of best practice on Corporate Governance as standard way. Also, the result presented in this study were restricted by less number of variables related to Board structure and data presenting for eleven Diversified Holdings companies as prescribed time of four years that will subject to data constrain. Therefore, it is suggested that future research should be carried out with a large number of variables on Board structure and data analysis for wide range of period to eliminate random fluctuations.

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